



December 14, 2011

Board of Governors of the Federal Reserve System  
20th and C Streets, N.W.  
Washington, D.C. 20551  
Attention: Jennifer J. Johnson, Esq., Secretary

Re: Docket Nos. 1433 and 1434—Reserves Simplification

Governors:

The Clearing House Association L.L.C. (“The Clearing House”)<sup>1</sup> is pleased to comment on the Federal Reserve Board’s proposal to simplify the administration of reserve requirements. The proposal includes an amendment to the Board’s Regulation D<sup>2</sup> to

create a common two-week maintenance period for all depository institutions, create a penalty-free band around reserve balance requirements in place of carryover and routine penalty waivers, discontinue as-of adjustments related to deposit revisions, replace all other as-of adjustments with direct compensation, and eliminate the contractual clearing balance program.<sup>3</sup>

Conforming amendments regarding as-of adjustments would also be made to Regulation J,<sup>4</sup> which governs the Federal Reserve Banks’ check-collection and

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<sup>1</sup> Established in 1853, The Clearing House is the nation’s oldest banking association and payments company. It is owned by the world’s largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs, and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the United States. See The Clearing House’s web page at [www.theclearinghouse.org](http://www.theclearinghouse.org) for additional information.

<sup>2</sup> 12 C.F.R. pt. 204.

<sup>3</sup> 76 Fed. Reg. 64,250 (Oct. 18, 2011).

<sup>4</sup> 12 C.F.R. pt. 210.

funds-transfer activities.<sup>5</sup> The Board proposes to eliminate the as-of adjustment in the first quarter of 2012 and implement the common reserve-maintenance period and related changes in the third quarter of 2012.

The Board believes that these changes will reduce the operational and administrative costs of the reserve requirements for both banks and the Federal Reserve.

#### SUMMARY

1. The Clearing House supports the proposed common two-week reserve maintenance period.
2. The Clearing House has no objection to the concept of a penalty-free band around reserve requirements to replace carryover, but we believe that the penalty-free rate should be set at the greater of \$50,000 or 4% of a bank's total reserve requirement.
3. While The Clearing House does not object to the elimination of the contractual clearing balance program under the current, unusual market conditions, it believes that to ensure that the new program works in more normal market conditions that the Board should announce that it will pay interest on reserves at a rate equal to or greater than the effective fed funds rate.
4. The Clearing House supports replacing the current as-of adjustments with direct compensation but believes that the Reserve Banks should set the compensation rate at the effective fed funds rate and the amount of detail that the Reserve Banks provide to depository institutions regarding compensation should be at least as detailed as the information that is provided with respect to as-of adjustments.

#### DETAILED COMMENTS

We note at the outset that the many of the proposed changes make sense only if banks continue to receive interest on reserve balances. Yet the Federal Reserve is not required to pay interest on reserves,<sup>6</sup> and there is no

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<sup>5</sup> 76 Fed. Reg. 64,259 (Oct. 18, 2011).

<sup>6</sup> "Balances maintained at a Federal Reserve bank by or on behalf of a depository institution may receive earnings to be paid by the Federal Reserve bank . . ." 12 U.S.C. § 461(b)(12)(A) (emphasis added).

guaranty that the policy will be always to pay interest. In order to alleviate any concern about these new policies, the Board should announce that it will pay interest on reserve account balances at the effective federal funds rate.

**1. The Clearing House supports the proposed common two-week reserve maintenance period.**

The heart of the simplification proposal is to reduce the current reserve maintenance periods to one common two-week period. Under the current system, a bank satisfies its reserve balance requirement on average over its reserve maintenance period, which can be a one-week period or a two-week period, with some banks passing back or forth between one-week and two-week maintenance periods. The Board's proposal will subject all banks to the same two-week period.

The Clearing House agrees that the common two-week period will reduce operational and administrative complexity and expenses for all banks and the Federal Reserve. Accordingly, we support this aspect of the proposal.

**2. The Clearing House has no objection to the concept of a penalty-free band around reserve requirements to replace carryover, but we believe that the penalty-free rate should be set at the greater of \$50,000 or 4% of a bank's total reserve requirement.**

Banks currently have the flexibility to make up for a deficiency in one maintenance period in the next period or to use an excess position in one period to satisfy the requirement in the next. While this arrangement does provide banks with welcome flexibility, it delays the payment of interest on excess reserves because it cannot be determined whether a bank has satisfied its reserve requirement for one maintenance period until the conclusion of the subsequent period. The Board proposes to replace the carryover with a penalty-free band equal to the greater of \$50,000 or 10% of the bank's aggregate reserve balance requirement.

The Clearing House has no objection to a penalty-free band, but does have some concern with how it would be calculated under the proposal. The current maximum carryover is calculated at the greater of \$50,000 or 4% of a bank's total reserve requirement. The 10% limit under the new proposal is applied not to the total reserve requirement, but only to the reserve *balance* requirement—i.e., the amount of the reserve requirement that is in excess of the bank's vault cash. This raises the question of how the Federal Reserve would

treat the band if in the future the Board reduces the reserve requirement so that all banks are able to meet their reserve requirements with vault cash and there are no excess reserve balances. In those circumstances, a bank's penalty-free band would be limited to \$50,000, and large banks would have a significant incentive to manage their reserve requirements in a way that would keep them within the \$50,000 band, for example by sweeping deposit balances into investment accounts to minimize the deposit balances subject to reserves. It is not clear what effect this would have on the Federal Reserve's management of reserves for monetary policy or how the Fed would react to this situation.

Because of this problem, The Clearing House believes that the penalty-free band should be set at the greater of \$50,000 or 4% of a bank's total reserve requirement.

- 3. While The Clearing House does not object to the elimination of the contractual clearing balance program under the current, unusual market conditions, it believes that to ensure that the new program works in more normal market conditions that the Board should announce that it will pay interest on reserves at a rate equal to or greater than the effective fed funds rate.**

The clearing balance program allows a bank to agree with its Federal Reserve Bank to maintain a level of balances in excess of the amount needed to satisfy its reserve requirement. These "clearing balances" generate earnings credits that can be used to offset the fees for the bank's use of the Reserve Banks' priced services. The clearing balance program thus allowed the Reserve Banks to pay implicit interest on excess reserve balances at a time when they were not permitted to pay explicit interest on reserves.

The Board notes that the program was initiated in part to "provide depository institutions that have low reserve balance requirements with an incentive to hold a level of balances that will facilitate clearing of payments and reduce overdrafts in their Reserve Bank accounts."<sup>7</sup> The clearing balance program does have a number of drawbacks, however: it is cumbersome to maintain and requires a legal agreement between a bank and its Reserve Bank. Now that banks are paid explicit interest on their reserve balances, the clearing balance program does not appear to serve a useful purpose, and the Board proposes to eliminate it.

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<sup>7</sup> 76 Fed. Reg. at 64,254.

The Clearing House believes that the Board should consider the differences between how the elimination of the clearing balance program will work in current market conditions and how banks will react when more normal conditions return. During the height of the recent financial crisis, the Federal Reserve flooded the banking system with excess reserves and kept interest rates abnormally low. Even though the crisis has abated somewhat, continuing concern for the economy has kept the Fed from draining reserves or returning interest rates to more normal levels.<sup>8</sup> Nevertheless, reserves and interest rates will eventually return to normal levels. When they do, banks will have fewer excess reserves and interest rates will be higher than they are now. These conditions will encourage the return of an active fed funds market, with banks trying to minimize their excess reserves by selling excess reserves when they are long and buying fed funds when they are short. This will, in turn, increase the possibility of overdrafts in reserve accounts because of payment activity.

In order to forestall this problem, The Clearing House believes that the Federal Reserve should announce that it will always pay interest on reserve balances at a rate that is equal to or greater than the effective fed funds rate. The Clearing House does not object to the elimination of the clearing balance program if the Board takes this action.

- 4. The Clearing House supports replacing the current as-of adjustments with direct compensation but believes that the Reserve Banks should set the compensation rate at the effective fed funds rate and the amount of detail that the Reserve Banks provide to depository institutions regarding compensation should be at least as detailed as the information that is provided with respect to as-of adjustments.**

The Federal Reserve uses as-of adjustments to offset errors in deposit reporting, correct transaction errors, and recover float. The Board believes that the payment of interest on balances maintained to meet reserve requirements eliminates the need for as-of adjustments for deposit revisions, and is therefore proposing to eliminate them for this purpose. The Board also proposes to:

1. Discontinue the use of as-of adjustments to correct transaction-related errors and instead use direct debits or credits to offset the effects of the error.

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<sup>8</sup> During the two weeks ending on November 30, 2011, excess reserves totaled \$1.497 trillion. See Federal Reserve Statistical Release, H.3—Aggregate Reserves of Depository Institutions and the Monetary Base (Dec. 8, 2011). The targeted fed funds rate is currently 0–0.25%, and the discount rate is 0.75%. See <http://www.frbdiscountwindow.org/index.cfm>.

2. Recover float through direct billing charges rather than as-of adjustments.
3. Address reserve deficiencies through the assessment of charges rather than with as-of adjustments.

The Clearing House has no objection to any of these changes, but notes that in order to properly compensate banks for transaction errors, the rate for calculating the compensation amount will have to be at least equal to the effective fed funds rate.

We also note that when Reserve Banks provide financial institutions with as-of adjustments they provide the institutions with a great deal of information about the factors that have gone into the calculation of the adjustment, e.g., the transaction-related errors and reserve deficiencies. In order to ensure that banks and other financial institutions understand the debits, credits, and charges, the Reserve Banks should continue to provide the same information for these items as they do for the as-of adjustments.

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We hope these comments are helpful. Please contact me at [joe.alexander@theclearinghouse.org](mailto:joe.alexander@theclearinghouse.org) or 212-612-9234 if you have any questions about the positions taken in this letter or if you would like to discuss the matter further.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Joseph R. Alexander", followed by a long horizontal flourish.

Joseph R. Alexander  
Senior Vice President, Deputy  
General Counsel, and Secretary